Internal Revenue Service
memorandum

CC:TL-N-10544-91
FS:IT&A:GJMerken

date: NOV - 1 '91

to: District Counsel, [redacted] CC:[redacted]

from: Assistant Chief Counsel (Field Service) CC:FS

subject: Application of Hamilton Industries, Inc. v. Commissioner, 97 T.C. No. 9 (July 30, 1991) to [redacted]

This is in response to your request for field service advice dated September 17, 1991.

ISSUE

Whether a taxpayer should be required to create a separate item for inventory purchased at a discount of either 58 percent or 26 percent in valuing base year cost under LIFO accounting.

CONCLUSION

Although the Tax Court has failed to set an exact standard to determine how large a bargain element is needed to require creating a separate item, the Service should apply the principle of Hamilton Industries, Inc. v. Commissioner, 97 T.C. No. 9 (July 30, 1991), in this audit to achieve the clear reflection of income.

FACTS

The [redacted] ([redacted]) had existed since the [redacted]. It produced lumber from [redacted] and [redacted]. In [redacted], [redacted] ([redacted]) bought [redacted] for $[redacted] in a cash for stock transaction. The appraised value of [redacted] was $[redacted]; [redacted] thus acquired [redacted] at a [redacted] percent discount from fair market value. [redacted]'s book value was only $[redacted] because the company in [redacted] had assigned a basis of $[redacted] per [redacted] board feet of lumber. To increase basis after purchasing [redacted], [redacted] elected under section 338 to substitute the cost of the stock for the book value of the logs, lumber, and retail operations, and allocated the cost among cash, marketable securities, and other assets. [redacted] allocated $[redacted] to the inventory of logs and lumber which had a fair market value of $[redacted].

[redacted] elected the dollar value, link-chain method of LIFO accounting in [redacted]. It designated the $[redacted] of purchased inventory as the base-year layer. Revenue Agent [redacted]'s chief concern is [redacted]'s combining the bargain purchase of inventory with inventory manufactured later in the tax year since this would distort income. He rejects [redacted]'s calculating a beginning LIFO inventory because beginning LIFO inventory by definition equals previous ending inventory; since this is a new corporation, no previous ending inventory existed. Agent [redacted] calculates a 58 percent bargain: allocation of $[redacted] against FIFO inventory value of $[redacted]. [redacted] calculates a 26 percent bargain: LIFO value of $[redacted] against ending inventory of $[redacted]. [redacted] has replied that (1) a 26 percent discount is not enough to require creating a separate item for the purchased inventory, and (2) the section 338 election forced it to value the inventory at $[redacted] in the first place rather than at fair market value of $[redacted].

Agent [redacted] proposes a $[redacted] increase in ending inventory to account for his position.

DISCUSSION

As discussed in Amity Leather Products Co. v. Commissioner, 82 T.C. 726 (1984), the basic principal of inventory accounting for tax purposes is the clear reflection of income. The LIFO method of inventory accounting serves to determine income more accurately by matching current costs against current revenues, thereby eliminating from earnings any artificial profits resulting from inflationary increases in inventory costs. In simple terms, the cost of goods most recently acquired is subtracted from the revenue generated by the first goods sold to determine gross income. This ensures that the cost of the earliest goods acquired, which presumably cost lower than later-acquired goods in an inflationary economy, remains in inventory and does not artificially inflate income.

The dollar value method of pricing LIFO inventories measures the change in the total dollar value invested in inventory. The Income Tax Regulations provide that to determine the annual change, ending inventory is valued in terms of total dollars that are equivalent to the dollars used to value the beginning inventory. Treas. Reg. § 1.472-8(a). The change in inventory value is determined with respect to the base year, or the year in which LIFO was elected. The base year provides a constant from which to measure changes in inventory values in later years. If the indexed value of ending inventory exceeds that of beginning inventory, then an increment in LIFO inventory occurs.

For administrative ease and to ensure a clear reflection of income, the regulations provide that "items" of a similar nature may be pooled. Treas. Reg. § 1.472-8(b). For example, while the manufacture of automatic clothes washers and driers of both commercial and domestic grades as well as electric ranges and dishwashers may properly be combined in a single pool, the manufacture of televisions and radios would constitute a second pool. Treas. Reg. § 1.472-8(b)(2)(ii)(Ex.1). The Court in Amity Leather, supra, cogently explained why the proper definition of items is so important:

> The nature of "items" in a pool must be similar enough to allow a comparison between ending inventory and base-year inventory. Because the change in the price of an item determines the price index and the index affects the computation of increments or decrements in the LIFO inventory, the definition and scope of an item are extremely important to the clear reflection of income. If factors other than inflation enter into the cost of inventory items, a reliable index cannot be computed. For example, if a taxpayer's inventory experiences mix changes that result in the substitution of less expensive goods for more expensive goods, the treatment of those goods as a single item increases taxable income. This occurs because any inflation in the cost of an item is offset by the reduction in cost resulting from the shift to less expensive goods. Conversely, if changes in mix of the inventory result in the substitution of more expensive goods for less expensive goods, the treatment of those goods as a single item decreases taxable income because the increase in inventory costs is eliminated from the LIFO cost of the goods as if such cost increase represented inflation.

Amity Leather at 733.

The Code and the regulations, however, do not define the word "item." In a series of cases the Tax Court has danced around the concept without setting a clear standard by which to determine when inventory elements may be combined. In Wendle Ford Sales, Inc. v. Commissioner, 72 T.C. 443 (1979), the Court held that the addition of solid-state ignition systems and catalytic converters to some new cars was "not so significant" to differentiate 1975 Fords and 1974 Fords for the dollar-value LIFO purposes of a Ford dealer. Wendle Ford at 459. The Court did not think differences between the two model years were "substantially sufficient" to warrant a separate item. Id. What would be "significant" or "substantially sufficient" was left unaddressed by the Court as it stated simply "the threshold point had not been crossed." Id. at 461.

In Fox Chevrolet, Inc. v. Commissioner, 76 T.C. 708 (1981), the Court again dealt with the retail motor vehicle industry. Taxpayer, a Chevrolet dealer, utilized a single LIFO pool for all new cars and trucks in its inventory. The Service contended that taxpayer must employ separate LIFO pools for each model line of cars and trucks. Finding the middle ground, the Court held that taxpayer must establish one pool for new automobiles, and one pool for new trucks. "On balance," the Court wrote, "[cars and trucks] are sufficiently dissimilar that we believe each represents a separate and distinct class of goods." Fox Chevrolet at 725. The Court failed to define "sufficiently dissimilar," and acknowledged that "the line is difficult to draw." Id. at 726. The Court noted, however, that it would combine light-duty, medium-duty, and heavy-duty trucks as one item. Id. at 725, n.4.

While Wendle Ford and Fox Chevrolet dealt with physical differences in retail goods, the Court in Amity Leather Products Co. v. Commissioner, supra, considered cost differences of identical goods. In that case, taxpayer manufactured leather billfolds in a domestic facility and bought identical billfolds for resale from a Puerto Rican affiliate at a lower price. The Court held that a separate pool must be established for the purchased inventory because taxpayer was effectively a wholesaler of the affiliate's goods. Furthermore, in order more accurately to eliminate the impact of inflation on taxpayer's inventory, the purchased inventory was to be considered a separate item. The determinant for this holding was cost: "[t]he Puerto Rican billfolds cost substantially less than the domestic billfolds to manufacture." Amity Leather at 740. Again, the Court failed to define "substantially less," giving little guidance for future situations.

UFE, Inc. v. Commissioner, 92 T.C. 1314 (1989), provided a decision on a single bargain purchase of inventory. In that case, a newly formed corporation acquired substantially all the assets of an ongoing business including its finished inventory. The Court, distinguishing the facts from Amity Leather, declined to require a separate LIFO pool for the bargain purchase of inventory. The Court explained Amity Leather as having set a standard of whether a taxpayer is engaged in a separate trade or business. In Amity Leather, the taxpayer continuously and regularly bought finished inventory from its affiliate; here, the taxpayer made a single purchase of inventory. In UFE, however, the Court did not address whether a bargain purchase of inventory must constitute a separate item within a LIFO pool.

In Hamilton Industries, Inc. v. Commissioner, 97 T.C No. 9 (July 30, 1991), the newly-formed taxpayer purchased the assets, including inventory, from an ongoing corporation at a steeply discounted price. The Court, based on UFE, rejected the Commissioner's attempt to require a separate pool for the bargain purchase of inventory. It held that "requiring separate pools would distort income" because the isolated purchase of inventory did not render the taxpayer a "dual function entity" as existed in Amity Leather. Hamilton at 23.

Nevertheless, the Court continued, a separate item would be required. The 96 percent and 60 percent bargain elements were "significantly large" enough to cause the inventory to "assume a different character from inventory purchased or produced at market prices, as represented by the FIFO value of the inventory, after the acquisition." Id. at 27. Combining the bargain cost inventory with goods carried at higher cost could artificially diminish income until taxpayer decided to liquidate the inventory. The Court noted that while not every bargain purchase of inventory would require creating new items in the LIFO pool, certainly where a taxpayer attempts to value its entire base year inventory at bargain cost such a requirement is proper. Id. at 29, n.6.[1]

From the foregoing discussion, it is clear that the Court is loath to formulate a standard to determine when a bargain purchase of inventory must constitute a separate item. It will analyze the facts in each case to decide whether income is clearly reflected. Peninsula Steel Products and Equipment Co. v. Commissioner, 78 T.C. 1029, 1045 (1982) ("whether a particular method of accounting clearly reflects income is primarily a question of fact"). This approach works in the Commissioner's favor, for he can assert ever narrower definitions of item to achieve the clear reflection of income.

In conclusion, the facts in the [redacted] audit are similar to those in Hamilton: taxpayer bought inventory at a bargain price as part of an overall acquisition and attempted to mix that inventory with more expensive inventory to establish a base year LIFO pool. The Court in Hamilton required creating a new item for inventory purchased at a 60 percent discount; in [redacted], depending on whether the Service or the taxpayer is correct, the discount is either 58 percent or 26 percent. We believe 58 percent to be the appropriate calculation; such a discount is certainly close enough to Hamilton to warrant pursuit of this issue. Even if [redacted]'s theory prevails, a 26 percent discount is worth pursuing on the ground that it materially alters the LIFO calculation by artificially reducing closing inventory.

---

[1] On September 30, 1991, counsel for Hamilton Industries moved to reconsider the case. The Tax Court, by Judge Thomas Wells, ordered respondent to file his objection, if any, to petitioner's motion by November 6, 1991. We will keep you apprised of any further opinion by the Tax Court, if any, on this motion.

If you have any further questions, please contact Gary J. Merken of this office at FTS 566-3442.

DANIEL J. WILES

By: Gerald M Horan

GERALD M. HORAN
Senior Technician Reviewer
Income Tax & Accounting Branch
Field Service Division